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No. 79-1154

In the Supreme Court of the United States

OCTOBER TERM, 1979

ANTHONY COLAO, ROY V. JOHNSON, MORRIS I. GINSBURG, PAUL J. MILLER, WILLIAM A. F. SMITH, GEORGE R. CABLE and HAROLD J. SEXTON,

Petitioners,

vs.

MERIT INSURANCE COMPANY, INC.,
an Illinois Corporation,

Respondent.

RESPONSE TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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Questions Presented

1. Did the Court of Appeals properly apply Rule 8 of the Federal Rules of Civil Procedure in not requiring the plaintiff in a diversity action to allege freedom from contributory negligence in pleading a negligence claim?

2. Did the Court of Appeals correctly determine that the plaintiff's complaint stated a cause of action against accountants for negligence under Illinois Law?

3. Did the Court of Appeals properly find that the evidence presented by plaintiff at trial established a prima facie case of fraud against the defendant accountants, so that reversal of the District Court's directed verdict in favor of the defendants was proper?

Statement of the Case

This is a diversity action involving allegations of common law fraud and negligence by accountants. The plaintiff is respondent Merit Insurance Company; the defendants, petitioners, are the partners and certain employees of Joseph Froggatt & Co., an accounting firm. Respondent alleges (1) that petitioners prepared and issued audited financial statements for an insurance agency, General Auto Placement, Inc. ("GAP"), (2) that the audit report contained several serious misstatements and omissions, and (3) that respondent relied on the audit report, to its detriment, in deciding to do business with GAP. Respondent alleged negligence and fraud by petitioners in alternative counts. The negligence count was dismissed before trial, and the case was tried only on the fraud count.

The trial was conducted before Senior District Judge Julius J. Hoffman sitting with a jury. Respondent presented its case for four months, from November 1, 1977 until February 28, 1978. During this time, Judge Hoffman excluded a large volume of the evidence introduced by respondent. With few exceptions, he sustained all of the evidentiary objections made by petitioners. No documents were admitted to which petitioners made objections. Hundreds of offers of proof were made; not once did Judge Hoffman reverse his previous ruling to permit the offered evidence to be admitted. At the end of four months, Judge Hoffman directed a verdict in favor of petitioners.

Respondent appealed to the Court of Appeals for the Seventh Circuit. The Court of Appeals reversed and remanded for a new trial before a judge of the District Court other than Judge Hoffman.

After reviewing the evidence, the Court of Appeals found that "despite the fact that much relevant evidence was not admitted" by Judge Hoffman, respondent nevertheless "presented sufficient evidence to establish a *prima facie* case of fraud . . . ." (Pet., p. 7a.) Because the court remanded for a new trial, it decided that "no purpose would be served in further marshalling" the erroneously excluded evidence. (*Id.*, p. 8a.) The court also reversed Judge Hoffman's dismissal of the negligence count. The petition for certiorari followed.

REASONS FOR DENYING THE WRIT OF CERTIORARI

Petitioners argue three points, none of which approaches the kind of important constitutional or policy question which this Court should exercise its discretion to hear.

I.

The Court of Appeals Correctly Recognized That Rule 8 Governs Pleadings in Federal Diversity Actions And That State Law Governs Burdens of Proof.

Petitioners first argue that the Court of Appeals "Created A Substantive Right . . . Which Is In Conflict With The Rule Of Law Set Down By This Court In Erie R. Co. v. Tompkins." (Pet., p. 5.) The basis for the argument is the Court of Appeals' reversal of Judge Hoffman's dismissal of Count I of the complaint. Count I stated a claim for negligence against petitioners but did not allege respondent's freedom from contributory negligence. Petitioners claim that the requirement of Illinois law that a plaintiff plead freedom from contributory negligence requires dismissal of the count for failure to state a cause of action.

The fallacy of the argument is its failure to recognize the distinction between pleading and proving contributory negligence. This distinction was recognized by this Court in *Palmer* v. *Hoffman,* 318 U.S. 109 (1943), the very case that petitioners cite in their petition. (Pet., p. 6.) The plaintiff there argued that the defendant had the burden of proving contributory negligence because Rule 8(c) of the Federal Rules of Civil Procedure made contributory negligence an affirmative defense. In response to the argument this Court stated:

> "We do not agree. Rule 8(c) covers only the manner of pleading. The question of the burden of establishing contributory negligence is a question of local law which federal courts in diversity of citizenship cases [citing *Erie*] must apply." 318 U.S. at 117.

The case clearly establishes the principle that the Federal Rules determine the sufficiency of pleadings while state law allocates burdens of proof in diversity cases. The sufficiency of a plaintiff's pleading is governed by Rule 8(a), which requires simply (1) a jurisdictional statement, (2) "a short and plain statement of the claim showing that the pleader is entitled to relief," and (3) a demand for judgment.

The case of *Francis* v. *Humphrey,* 25 F.Supp. 1 (E.D. Ill. 1938), cited by petitioners (pet., p. 6), is to the contrary but is out of date. It was decided at a time when "the burden of pleading was inextricably intertwined with the burden of proof so that the party having the burden of pleading a certain matter likewise had the ultimate burden of proving it." *Gilmore* v. *Witschorek,* 411 F. Supp. 491, 495 (E.D. Ill. 1976). After the decision in *Francis* v. *Humphrey,* this Court in *Palmer* made it clear that the burden of pleading and the burden of proof are controlled by different rules, and at least two federal courts have since rejected the earlier holding. *Gilmore* v. *Witschorek, supra; Klondike Helicopters, Ltd.* v. *Fairchild Hiller Corp.,* 334 F.Supp. 890, 896 (N.D. Ill. 1971).

The case of *Sundstrand Corp.* v. *Standard Kollsman Industries, Inc.,* 488 F.2d 807, 813 (7th Cir. 1973), also cited by petitioners (pet., p. 10), is not to the contrary. It holds, significantly, that (1) burden of proof is a matter of substantive law to be decided by application of local law under the *Erie* doctrine, and (2) a defendant needs to plead affirmatively under Rule 8(c) only those defenses for which he bears the burden of proof. The case gives no consideration to what a plaintiff must plead. The remain-

ing authorities cited by petitioners are cases decided under the *Erie* doctrine and have little relevance to the issue raised here.

Finally, while petitioners emphasize that the Court of Appeals panel was not unanimous in its reversal of Judge Hoffman, they neglect to point out that all the judges below were unanimous in rejecting petitioners' first and lengthiest argument for granting their petition. Judge Harlington Wood, the dissenting judge in the Court of Appeals, stated categorically that "plaintiff need not allege due care" in its complaint for negligence. (Pet., p. 20a.) And, while Judge Hoffman in the District Court dismissed Count I on other grounds, he too held:

> "The drafters of the Federal Rule have provided members of the Federal Bar with sample forms to be considered as examples of notice pleading. Form 9 indicates the brevity with which negligence is to be alleged. It is not within the contemplation of those authors to dismiss a negligence count for failure to allege the exercise of due care and caution on the part of the plaintiff." Tr. of Proceedings, April 8, 1977, p. 15 (see appendix p. 2).

Had failure to allege absence of contributory negligence been the basis for dismissal of Count I, respondent would simply have amended its complaint.

II.

In Reversing Dismissal Of The Negligence Count, The Court Of Appeals Correctly Anticipated Illinois Law In The Area of Negligent Misrepresentations.

Petitioners' second argument is that the Court of Appeals erred in reversing the dismissal of Count I because an action against accountants for negligence has never been considered or authorized by Illinois courts. Petitioners also contend that "every indication" suggests that Illinois courts would not permit such an action, although the only Illinois case they cite is the same one relied upon by the Court of Appeals. (Pet., p. 12.) Both points fall far short of constitutional significance; neither is a matter of material significance.

Where state courts have not decided an issue raised before a federal court sitting in diversity jurisdiction, the federal court is required, not to abstain, but to predict how those state courts would decide the issue when presented with it. *Bernhardt* v. *Polygraphic Co. of America,* 350 U.S. 198, 209-212 (1956) (Frankfurter, J., concurring); *Holt* v. *Seversky Electronatom Corp.,* 452 F.2d 31, 34 (2d Cir. 1971). In doing so, the federal court may reasonably extend the case authorities that appear to effectuate the current policies of the state. See *Bowen* v. *United States,* 570 F.2d 1311, 1322 (7th Cir. 1978). The fact that Illinois courts had not specifically considered whether accountants may be held liable for negligence was thus clearly no bar to the decision of the Court of Appeals.

As the Court of Appeals recognized, *Rozny* v. *Marnul,* 43 Ill.2d 54, 250 N.E.2d 656 (1969), is the "controlling authority" in Illinois in the area of negligent misrepresentations. (Pet., p. 9a.) *Rozny* dealt with the liability of a land surveyor rather than an accountant, but the Illinois Supreme Court there referred to and reasoned from cases in which an accountant was held subject to liability for negligence. See *Rusch Factors, Inc.* v. *Levin,* 284 F.Supp. 85 (D.R.I. 1968), and *Fischer* v. *Kletz,* 266 F.Supp. 180 (S.D.N.Y. 1967), cited in *Rozny,* 43 Ill.2d at 67, 250 N.E.2d at 663. The Illinois Supreme Court in *Rozny* held the defendant surveyor liable for negligent misrepresentation to plaintiff homeowners who eventually acquired the parcel of land surveyed by the defendant. In doing so the court re-

jected the old common law requirement of a contractual relationship in a case alleging negligent misrepresentation, stating that "tort liability will henceforth be measured by the scope of the duty owed rather than the artificial concepts of privity." 43 Ill.2d at 62, 250 N.E.2d at 660.

The primary issue before the Court of Appeals was not, as petitioners suggest, whether accountants could be held liable under the reasoning of *Rozny*. Clearly they could. Rather, the issue was whether the facts alleged in respondent's complaint brought the case within *Rozny's* requirement that liability for a negligent misrepresentation be limited "to a comparatively small group, and that, ordinarily, only one member of that group will suffer loss. . . ." 43 Ill.2d at 67, 250 N.E.2d at 663. The Court of Appeals held that the complaint, liberally construed under Rule 8(a), sufficiently alleged that petitioners knew that a limited class might rely on the audit report. (Pet., p. 10a.)

Should this Court grant the petition for certiorari, it will again be faced with the question of the sufficiency of the complaint's allegations under *Rozny*. We submit that the Court of Appeals' decision was manifestly correct. The issue is not the kind of important state or federal question that needs to be decided by this Court, especially when the case has been remanded for a new trial.

III.

The Court of Appeals Correctly Determined That The Evidence At Trial Established A Prima Facie Case Of Fraud.

For their third argument petitioners abandon all pretense of formulating an appropriate issue upon which to base the granting of their petition and ask this Court to review the transcript covering a 17 week trial in order to

determine whether the Court of Appeals was correct in concluding that respondent presented a prima facie case of fraud. Specifically, petitioners contend that respondent failed to establish (1) that it had a "right to rely" on petitioner's audit report or (2) that its damages were not caused by the fraud of some third parties. (Pet., pp. 15-16.)

This response is not the proper place for an extensive review of the evidence on respondent's right to rely or the cause of its damages. Nor is the Supreme Court of the United States the proper forum in which such a review should be made. Suffice it to say that, as to reliance, respondent's president testified that the audit report induced him to follow through with GAP, that he was particularly impressed with the "clean opinion" given by petitioners, and that petitioners were a well-known accounting firm in the insurance field. This testimony, as held by the Court of Appeals, created a jury question as to whether respondent was justified in relying on the audit report. (Pet., p. 18a.) The audit report, moreover, was not 16 months old when respondent first received it, as petitioners contend. (Pet., p. 16.) The report was dated July 15, 1971, and respondent received it in April of 1972. It was the most current certified financial information available for GAP, and it fraudulently misrepresented the financial condition of GAP for the time period covered by the audit.

As to damages, Judge Hoffman refused to permit any evidence until, in his view, respondent established liability. Because he found that liability was never established, he gave respondent no opportunity to submit evidence on damages and causation. Petitioners' argument on the cause of respondent's losses is thus hypothetical and misleading. The fraudulent conduct of third parties will not, in any event, excuse petitioners' own fraud, as petitioners seem to suggest. *McRoberts* v. *Combination Fountain Co.*, 317 Ill. 165, 170-171, 147 N.E. 785, 787 (1925); Prosser, *Law of Torts* 715 (4th ed. 1971).

CONCLUSION

The issues raised by the petition are plainly without merit. The petition should be denied forthwith.

Respectfully submitted,

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Dated: February 25, 1980

APPENDIX

APPENDIX

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 75 C 899

MERIT INSURANCE COMPANY,

Plaintiff,

vs.

ANTHONY COLAO, et al.,

Defendants.

TRANSCRIPT OF PROCEEDINGS

had in the above-entitled cause before the HON. JULIUS J. HOFFMAN, one of the Judges of said Court, in his courtroom in the United States Courthouse, Chicago, Illinois, on Friday, April 8, 1977, at the hour of 10:00 o'clock a.m.

* * *

We come now to the consideration of Counts I and II alleging a cause of action based upon the negligence—rather the negligent preparation of financial statements by the Froggatt firm. Count II contains similar factual allegations, but alleges "gross negligence" on the part of Froggatt.

The defendants seek dismissal of both counts for a variety of reasons. The counts are initially challenged for failure to specifically plead the plaintiff's exercise of due care. Under the laws of the State of Illinois, a plaintiff must plead and prove exercise of due care and caution at the time of the incident in question. Faber v. General Telephone Co. of Illinois, 19 Il.App.3d 135, 311 N.E.2d 281 (1974); Kray v. Ricci, 14 Il.App.3d 904, 303 N.E.2d 458 (1973).

However, under the Federal Rules of Civil Procedure there is no requirement that negligence be alleged with specificity. Although the substantive law of the State of Illinois must govern this action, the rigid requirements pleading facts utilized by the State's judicial system is not thereby incorporated.

The drafters of the Federal Rule have provided members of the Federal Bar with sample forms to be considered as examples of notice pleading. Form 9 indicates the brevity with which negligence is to be alleged. It is not within the contemplation of those authors to dismiss a negligence count for failure to allege the exercise of due care and caution on the part of the plaintiff.

The defendants similarly contend that the plaintiff has failed to allege facts showing a right to rely on the financial statements at issue.

Unlike a cause of action for fraud, justifiable reliance is not an element which must be proved to recover under a negligence theory. While evidence of the age of the financial statements might be admissible on the issue of contributory negligence, age is not a basis for dismissal of these counts.

The primary substantive contention raised by the parties relates to the question of the duty owed by Froggatt

to the plaintiff. As this issue is before the District Court pursuant to its diversity jurisdiction, the scope of duty is to be measured by reference to the laws of the State of Illinois. While the courts of several states have addressed this issue, the Illinois Supreme Court has not been called upon to consider the extent of an accountant's professional liability. Thus, the Court must decide this issue as it believes the Illinois courts would rule upon it. Walker v. Kruse, 484 F.2d 802, Seventh Circuit (1973).

As Justice Frankfurter observed in Bernhardt v. Polygraphic Company of America, Inc., 350 U.S. 198, 209:

> "As long as there is diversity jurisdiction, estimates are necessarily often—necessarily often all that the federal courts can make in ascertaining what the state court would rule to be its law."

• • •